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**NYNEX**

June 11, 1996

**Ex Parte**

Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, NW  
Room 222  
Washington, DC 20554

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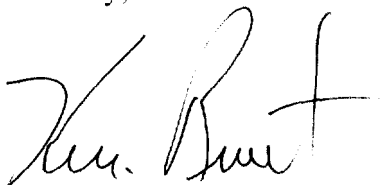
**Re: CC Docket No. 96-45**

Dear Mr. Caton:

The attached letter was sent to Chairman Hundt with regard to the above-referenced docket. Please insert these documents into the record.

Any questions on this matter should be directed to me at either the address or the telephone number shown above.

Sincerely,



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NYNEX Revoice

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**Frank J. Gumper**

Vice President, Federal Regulatory Planning



June 11, 1996

Honorable Reed E. Hundt, Chairman  
Federal Communications Commission  
1919 M Street, NW  
Washington, DC 20554

Re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45.

Dear Chairman Hundt:

At the Joint Board hearing on June 5, 1996, you asked a representative of the local exchange carriers ("LECs") whether he agreed that Total Service Long Run Incremental Cost ("TSLRIC"), as represented by the MCI's "Hatfield Model," included all of a LEC's costs, including its joint and common costs and its capital costs. NYNEX does not feel that the answer you received adequately conveyed the serious and fundamental flaws in the Hatfield Model, or the general problems associated with TSLRIC. Therefore, we submit the following points:

**The Hatfield Model does not represent TSLRIC.** The Hatfield Model is not based on real costs -- it is a "blank slate" model of a hypothetical LEC network that might be constructed from scratch using the lowest-cost technology available today. It does not represent, in any way, the incremental costs that a LEC will actually incur to provide a service or a facility.<sup>1</sup> For this reason, it is inconsistent with the economic theories supporting TSLRIC pricing. The purpose of incremental pricing is to inform buyers of the costs that they impose on a firm, and on society, if they purchase the firm's output. This leads to an efficient allocation of society's resources, and it ensures that the most efficient firm will be chosen. The TSLRIC blank slate methodology contradicts this economic principle by misinforming the purchaser about the producer's actual incremental cost. Therefore, TSLRIC blank slate is fundamentally inconsistent with efficient, or "economic," pricing.

**The Hatfield Model grossly underestimates network investment levels.** The authors of the Hatfield Model believe that they can design a "more efficient" nationwide telephone network on a personal computer using a handful of parameters, such as distance, population density, and soil conditions. This does not begin to represent all of

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<sup>1</sup> See Implementation of Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, Reply Comments of Bell Atlantic, filed May 30, 1996, Declaration of Alfred E. Kahn and Timothy J. Tardiff, p. 3 ("Kahn Affidavit").

the factors that a LEC must take into account in building a network that will meet the needs of its customers.<sup>1</sup> No one has shown that a LEC could provide quality service with the "bare bones" network contained in the Hatfield Model. Indeed, the interexchange carriers want the ability to purchase unbundled network elements from the LECs because they do not believe that they could build a new local network at the same cost as the existing LEC network.<sup>2</sup>

MCI argues that the huge discrepancy between the results of the model and the LECs' actual investments are due to excess capacity in the LEC networks. However, the discrepancy merely illustrates the fundamental flaw in the Hatfield Model. All telecommunications networks are engineered with sufficient capacity to handle peak demand and growth. When a carrier builds transmission plant, it does not install just enough capacity to handle current demand -- it builds enough capacity to handle demand until the next upgrade. This represents efficient design. For example, the Commission noted in Docket 96-61 that AT&T's competitors have enough "excess capacity" to handle two-thirds of AT&T's traffic within 12 months.<sup>3</sup> Since those companies are, in the Commission's view, in competitive markets, this shows that the bare-bones capacity levels in the Hatfield Model are not representative of a network under competitive market conditions.

**The Hatfield Model "disallows" major portions of the LECs' current expenses.** The Hatfield Model uses self-serving assumptions to substantially underestimate the LECs' expenses. For instance, Hatfield decided that the LECs' administrative and overhead costs "seemed excessive," so he used a 6 percent factor from other industries.<sup>4</sup> Hatfield used a 10 percent cost of capital, regardless of the fact that massive disallowance's of the LECs' existing investments would increase the risk, and the cost of capital, for further investments in the local exchange business. Hatfield assumed that certain network expenses varied with the dollar level of investment, which compounded the problem of underestimating the amount of network investment, and he completely omitted corporate operations and customer operations expenses.<sup>5</sup> In other words, Hatfield treats this as a rate case, in which he decides that certain costs are unreasonable by reference to some type of ratemaking standard, exactly the result that Congress tried to avoid when it enacted the Telecommunications Act of 1996.

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<sup>1</sup> Since MCI has chosen not to put its model on the record, it is impossible for NYNEX to fully explore the model or to test its assumptions. Most of the information that NYNEX has been able to glean about the model has come from the descriptions that MCI and AT&T attached to their comments in the Docket 96-98 interconnection proceeding. This is in contrast to the Benchmark Cost Model, which NYNEX and the other sponsors made available to the industry during the universal service fund investigation. The Commission should not give the Hatfield Model any credence until it has been subject to analysis by interested parties in all proceedings where it has been cited by MCI.

<sup>2</sup> See, e.g., AT&T Comments, CC Docket No. 96-98, filed May 16, 1996, p. 75 n.108.

<sup>3</sup> See Policy and Rules Concerning The Interstate, Interexchange Marketplace, CC Docket No. 96-61, Notice of Proposed Rulemaking, March 25, 1996, p. 30 n. 121.

<sup>4</sup> See MCI, The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, p. 30.

<sup>5</sup> See *id.* at pp. 29, 43-44.

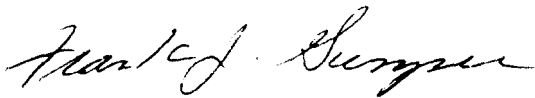
**The net effect of the Hatfield Model is confiscatory.** As MCI admits, the model produces costs that are only 44% of the LECs' existing revenue requirements.<sup>1</sup> It is inconceivable that a LEC could stay in business if it could not recover over half of its current costs. Even if the model were used only to reprice access services, it would be devastating to the LECs. For example, if the model were used to reduce NYNEX's access rates by 50%, NYNEX would lose approximately \$1.5 billion in annual revenues. To put that amount in perspective, it is more than NYNEX Corporation's entire annual earnings from all of its operations.

NYNEX is working on a computer model that will estimate the actual effect of TSLRIC blank slate pricing on a LEC's revenues. However, it is obvious, at this point, that rates based on the Hatfield Model would provide no incentive to invest in the network, assuming that the capital markets would provide the funds for such investment.

**Joint and common costs must be added to TSLRIC pricing to produce "economic" rates.** Even if the flaws in the Hatfield Model were corrected, and the Commission adopted a TSLRIC model that used the LECs' actual investments, it would not produce "economic" rates. TSLRIC pricing of all of a company's output would not cover all of its joint and common costs.<sup>2</sup> Therefore, as the Commission recognizes,<sup>3</sup> joint and common costs must be added to TSLRIC pricing to allow a LEC an opportunity to recover the costs that it incurs to provide all of its services.

For these reasons, NYNEX opposes use of TSLRIC pricing in general, or the Hatfield Model in particular, to set interconnection rates or to determine costs for purposes of developing universal service support levels. The Commission should not adopt a pricing model that inherently underestimates the actual costs that the LECs will incur to provide interconnection and universal service.

Sincerely,



cc: Joint Board Members

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<sup>1</sup> See MCI Comments, CC Docket No. 96-98, filed May 16, 1996, pp. 73-74.

<sup>2</sup> See Kahn Affidavit at pp. 5-6.

<sup>3</sup> See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Notice of Proposed Rulemaking, FCC 96-182, released April 19, 1996, para. 129.